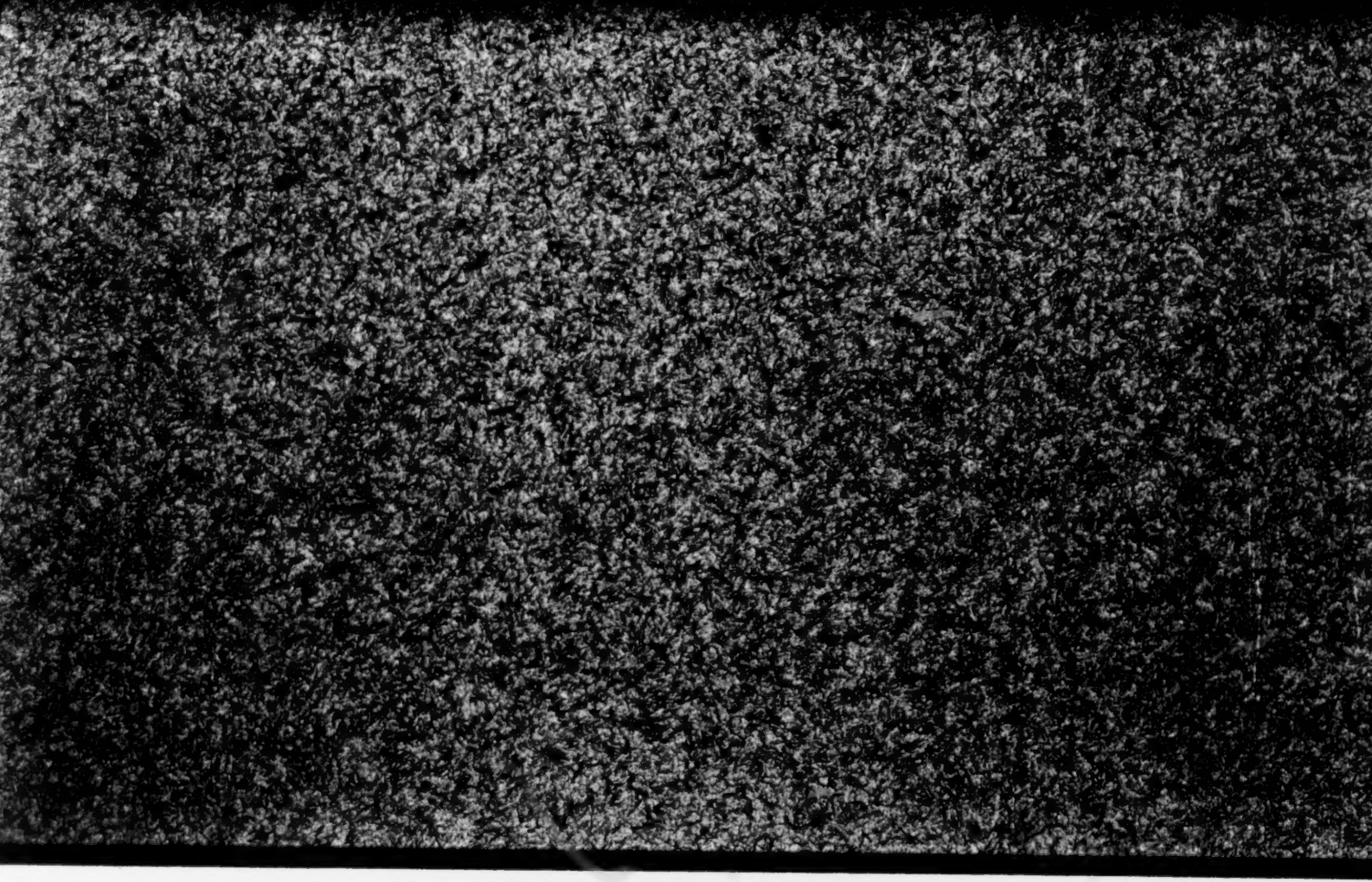

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1934.

No. 107.

OLD MISSION PORTLAND CEMENT COMPANY,
a corporation, PETITIONER,

v.

GUY T. HELVERING, as Commissioner of Internal Revenue, RESPONDENT.

BRIEF OF PETITIONER ON WRIT OF CERTIORARI TO THE U. S. CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

I. THE OPINION OF THE COURT BELOW.

The opinion of the U. S. Circuit Court of Appeals, Ninth Circuit, is reported at 69 Fed. (2d) 676, and is set out on pages 341-355 of the printed record. The Court's judgment appears on pages 355-6 of the record.

The opinion of the Board of Tax Appeals is reported at 25 B. T. A. 305 and is set out on pages 59-91 of the record.

II. JURISDICTION.

The jurisdiction of this Court is invoked under Section 240 of the Judicial Code as amended by the Act of February 13, 1925 (U. S. C., Title 28, Sec. 288) and under Section 1003 of the Revenue Act of 1926 (U. S. C., Title 26, Sec. 1226).

A petition for certiorari was filed June 12, 1934, and was granted October 8, 1934.

III. STATEMENT OF THE CASE.

The Old Mission Portland Cement Company, petitioner, is a California Corporation organized in 1912 and engaged in the manufacture of Portland cement, with principal office at San Francisco, California (R. 61). For the years 1923 to 1926, inclusive, it filed consolidated income tax returns for itself and the California Central Railroad Company (R. 76).

The California Central Railroad Company was organized in 1912 and at that time it issued its stock and bonds at a discount for assets of the San Juan Pacific Railway Company. In amortizing the bond discount over the life of the bonds, the amount of amortization applicable to each of the four years 1923, 1924, 1925, and 1926 is $3,381.18 (R. 76).

Soon after the California Central Railroad Company had issued its stock and bonds, the stock was acquired by petitioner, and petitioner has continued to hold said stock throughout the years 1923 to 1926, inclusive, so that the two corporations were affiliated during those years for income tax purposes (R. 76).

From time to time petitioner acquired outstanding bonds of the California Central Railroad Company and even acquired some of them in 1926 (R. 231, 271). In computing consolidated net income for the four years in question, respondent allowed as a deduction for amortization of the aforesaid bond discount the sum of $375.99 in the years 1923, 1924, and 1925 and the sum of $220.79 in the year 1926. The balance of the bond discount disallowed in each year

by respondent, represented the amount of discount applicable to the bonds held by petitioner during these years (R. 76-7).

Petitioner appealed to the Board of Tax Appeals, claiming the right to deduct the total bond discount applicable to the respective years in computing consolidated net income for those years (R. 40, 42). The Board sustained the action of the respondent (R. 89) and the Circuit Court affirmed the Board (R. 351-3).

In each of the years 1923 to 1926, inclusive, petitioner contributed $1,000.00 to the San Francisco Community Chest and claimed the amounts as deductions from income in its income tax returns for the respective years. Respondent disallowed the deductions (R. 69). Petitioner appealed to the Board of Tax Appeals, claiming the contributions as deductions (R. 40-41, 69), but the Board sustained respondent's action (R. 88) and the Circuit Court affirmed the Board (R. 354).

Petitioner and the California Central Railroad Company kept books and rendered consolidated income tax returns on the accrual basis (R. 76).

IV. THE LAW.

The statutes and regulations involved are as follows:

Revenue Act of 1921:

> "Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

(Sections 234 (a) (1) of the Revenue Act of 1924 and 1926 are identical.)

Treasury Regulations 62 (Rev. Act of 1924):

> "Art. 545.
> (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds."

(Articles 545 of Treasury Regulations 65 (Revenue Act of 1924) and 69 (Revenue Act of 1926) contain the same provisions.)

> "Art 636. Consolidated net income of affiliated corporations. — Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of inter-company transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated."

(Article 636 of Regulations 65 (Revenue Act of 1924) and Article 635 of Regulations 69 (Revenue Act of 1926) contain identical provisions.)

V. SPECIFICATIONS OF ERROR.

1. The Circuit Court of Appeals, Ninth Circuit, erred in holding that the total deductions taken by the California Central Railroad Company in computing its taxable net income for the years 1923 to 1926, inclusive, in amortizing the discount at which it sold its bonds, are not deductible in the consolidated income tax returns of such company and petitioner, for said years, even though petitioner was the owner of part of the bonds during such years.

2. The Circuit Court of Appeals, Ninth Circuit, erred in holding that contributions made by petitioner to the San Francisco Community Chest during the years 1923 to 1926, inclusive, were not deductible in computing taxable net income for those years.

VI. ARGUMENT.

1. The Circuit Court of Appeals, Ninth Circuit, erred in holding that the total deductions taken by the California Central Railroad Company in computing its taxable net income for the years 1923 to 1926, inclusive, in amortizing the discount at which it sold its bonds, are not deductible in the consolidated income tax returns of such company and petitioner, for said years even though petitioner was the owner of part of the bonds during such years.

The facts are set out above and need not be repeated here.

In its Opinion, wherein it sustained respondent's action, the Board of Tax Appeals did not discuss this issue but contented itself by saying (R. 89):

> "The facts of record do not distinguish the situation here presented from that ruled upon in New Orleans, Texas & Mexico Railway Co., 6 B. T. A. 436, 441, wherein we held that such bond discount was not deductible. Following that decision, the respondent's action in this particular is sustained. See also Gulf, Mobile & Northern Railroad Co., 22 B. T. A. 233, 261, wherein we followed our earlier decision on this point" (R. 89).

Likewise the Circuit Court of Appeals did not discuss the question except to say:

> "Under these regulations the Commissioner and the Board of Tax Appeals have uniformly held that the acquisition of bonds of a subsidiary company by a parent company, as in this case, are inter-company transactions, and the amortization of discount on such bonds is not deductible in a consolidated return. While the point is not without difficulty, we are unable to say that the determination of the Board of Tax Appeals is not correct" (R. 353).

If petitioner understands the Circuit Court, its decision

rests on the proposition that the acquisition of the bonds of the California Central Railroad Company by petitioner from third parties, long prior to the incidence of the consolidated returns provisions of the tax law, constitutes an inter-company transaction; and that this had the effect of wiping out the bond discount asset on the books of the subsidiary—that is, it was the same as if the California Central had redeemed its own bonds and realized the total loss at that time. But was that an inter-company transaction? And did the California Central *realize its loss* at that time?

To be an inter-company transaction both companies must be involved or affected in some manner. That is what the term "inter-company" means. *Gould Coupler Co.*, 5 B. T. A. 499. It is obvious that the California Central Co. was not affected when petitioner purchased its bonds from third parties, any more than it would have been affected if some other company had purchased them.

If it could be assumed that the California Central Company was affected to the extent of wiping out the unamortized bond discount on its books, what would have happened if petitioner had sold the bonds a year later? Would the unamortized discount be restored as an asset—a deferred charge—again to be amortized over the remaining life of the bonds? Obviously, the California Central Company's assets cannot be juggled in any such manner.

The point is that petitioner bought the bonds and held them as an investment the same as any other investment. Upon disposition of them it must account for profit or loss based upon its cost, whether or not it is affiliated with the California Central Company for tax purposes. *Commissioner of Internal Revenue* v. *The Van Camp Packing Company, Inc.*, 62 Fed. (2d) 596. If it holds them until maturity or until the California Central Company pays them, the act of payment may constitute an inter-company transaction, but that does not change the fact that the California Central Company has suffered a detriment—a loss—equal to the discount. Treasury Regulations provide that this loss shall

be taken in installments through equal annual deductions over the life of the bonds. Art. 545, Reg. 62, *supra.*

The question here is *not* whether the acquisition of the bonds by petitioner long prior to the taxable years was an inter-company transaction, but *whether the deduction by the California Central Company of that part of the bond discount applicable to the years in question was an inter-company transaction.*

The California Central Company paid interest each year on its bonds held by petitioner. Such interest payment *was* an inter-company transaction. The California Central Company deducted the amount of interest paid in its income tax return, and petitioner included that amount as income in its return. Thus, when the two returns are brought together in a consolidated return, one amount washes the other and both items are therefore eliminated. That is a typical illustration of an inter-company transaction. *Gould Coupler Co., supra.*

But, when an item entering into the computation of income of one member of an affiliated group does not appear conversely in the income of another member, it is *not* an inter-company transaction and is *not* eliminated from the consolidated net income. Such an item was the bond discount item, which the California Central Railroad Company deducted in each of the years in question. This deduction did not represent income to petitioner because petitioner did not receive anything and made no entries whatever on its books in respect thereof. Not only were the net assets of the California Central Company reduced each year by the amount of the deduction, *but likewise the total net assets of both companies together were that much less.* Therefore, it was not an inter-company transaction, and should be allowed as a deduction in consolidated net income just the same as any other deduction of the California Central Railroad Company, which was not income to the taxpayer. Art. 636 of Regulations 62 (*supra*).

It must be remembered that the writing off of the bond discount by the California Central Railroad Company was

the amortizing of a deferred charge which it incurred through sales of its bonds years before and before petitioner was the owner of them, or any of them. This writing off is the regularly recognized and authorized method of taking care of bond discount when corporations are on the accrual basis, as in this case, and is in conformity with Treasury Department regulations. See Article 545 of Treasury Regulations No. 62, 65, and 69 (*supra*). Petitioner will realize 100 cents on the dollar at maturity for the bonds which it holds of the California Central Railroad Company, so the writing off of this loss by the California Central in no way affects petitioner. Since the California Central could not write off the total discount as the bonds were sold, *to deny it the right to amortize the amount over the period is to deny it the loss altogether.*

It is not believed that respondent would have disallowed the deductions here questioned but for the Board's decision in the *New Orleans, Texas and Mexico Railroad Company* case, cited in the excerpt from the Board's opinion (*supra*). It is therefore pertinent to examine the Board's decision and the facts in that case.

An examination of that case discloses the fact that the Board did disallow the deduction for bond discount incurred under circumstances almost identical with those in the instant case, but the Board did not discuss the issue and rested its decision on the case of *Gould Coupler Company,* 5 B. T. A. 499. The latter case decided another issue altogether and furnishes no authority whatever for the position taken by the Board in the *New Orleans, Texas and Mexico Railroad Company* case.

Consideration of the *Gould Coupler Co.* case, however, is very enlightening in connection with the instant question. There the Board discussed at length the nature of consolidated income in the light of the legislative history of the provision. It sets forth the view that Congress intended consolidated income to be the income of the affiliated group as one economic unit, and points out that "the loss of any member is a loss of the group." In the light of this dis-

cussion it appears that petitioner's contention in the instant case is sound because, if the California Central Railroad Company and petitioner are considered as an economic unit, the unit would still be entitled to the deduction claimed.

Since Article 636 of Regulations 62 (1921 Revenue Act) *supra,* and all Regulations since that time provide that consolidated net income is "the combined net income of the several separate corporations," subject only "to the elimination of inter-company transactions," and since the deduction of bond discount by the California Central Railroad Company is not an inter-company transaction, it follows that the Circuit Court erred in affirming the Board in denying the deduction.

2. The Circuit Court of Appeals, Ninth Circuit, erred in holding that contributions made by petitioner to the San Francisco Community Chest during the years 1923 to 1926, inclusive, were not deductible in computing taxable net income for those years.

During each of the years 1923 and 1926, inclusive, petitioner donated $1,000 to the San Francisco Community Chest. Respondent disallowed these deductions in his computation of income for the respective years and the Board and the Circuit Court approved respondent's action (R. 69, 73, 88, 354).

The law involved here is Section 234 (a) (1) of the Revenue Acts of 1921, 1924, and 1926 (*supra*), providing for the allowance as deductions of all "ordinary and necessary expenses" incurred in carrying on any trade or business.

The Board has heretofore recognized that so-called donations are very often in fact business expenses, deductible under this provision of the law in computing income.

Poinsett Mills, 1 B. T. A. 6;
Anniston City Land Co., 2 B. T. A. 526;
Richmond Hosiery Mills, 6 B. T. A. 1247;
Superior Pocahontas Coal Co., 7 B. T. A. 380;
Ranier Grand Co., 11 B. T. A. 520;

Hirsh-Weis Mfg. Co., 14 B. T. A. 796;
Los Angeles and Salt Lake R. R. Co., 18 B. T. A. 168;
First National Bank of Omaha, 18 B. T. A. 1358;
The Killian Co., 20 B. T. A. 80.

The Courts have also recognized the fact that the Commissioner of Internal Revenue has frequently gone too far in disallowing business expenses on the theory that they were contributions and not deductible in computing income.

Corning Glass Works v. *Com.*, 37 Fed. (2d) 798;
American Rolling Mill Co. v. *Com.*, 41 Fed. (2d) 314;
The Forbes Lithograph Mfg. Co. v. *White*, 42 Fed. (2d) 287.

In *A. Harris & Co.* v. *Lucas* (5 C. C. A.), 48 Fed. (2d) 187, it was held that the two words "ordinary" and "necessary" are not used conjunctively and that Congress had in mind either ordinary or necessary expenses as being allowable deductions. But it matters not what construction is placed upon the phrase, it still follows that contributions, in the case of business corporations, are both very ordinary, in the sense of being of frequent occurrence, and are very necessary, if corporations expect to continue in business.

Webster's dictionary defines "ordinary" as meaning usual, common or customary.

In *Welch* v. *Helvering*, 290 U. S. 111, Mr. Justice Cardozo speaking for this Court said:

> "Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are common and accepted means of defense

> against attack. Cf. *Kornhauser* v. *United States,* 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type."

Corporations have no soul and business corporations exist for the purpose of earning profit. It can hardly be assumed that such corporations would from choice reduce their profits by making charitable donations. The logical assumption is—and this is common knowledge among those who understand business—that corporations make their donations either to encourage and increase business, or to avoid adverse criticism and disfavor among the public, which would result in a loss of business. Either purpose is bona fide and legitimate and brings the contributions within the class of ordinary business expenses. *Kornhauser* v. *U. S.,* 276 U. S. 145.

Mr. Herbert Coffman, a witness on behalf of petitioner, testified that the San Francisco Community Chest was similar to organizations of that kind in the East and that, instead of having different associated charities coming around from time to time and asking for gifts and donations, they were all put into one lump sum in the Community Chest and they had one visit a year. He stated that it was practically necessary for petitioner to make these donations from a business standpoint; that they were all expected to contribute; that publicity was given to the contributions by publication of the list of contributors; that if his company, petitioner, had not been on the list, they would have been overrun with people wanting to know what was the trouble and why they had not contributed their share; that the biggest market for the output of their cement plant was in San Francisco and that it would have been a reflection upon petitioner not to have made the donations requested. When Mr. Coffman was asked if, in his opinion, a business could successfully operate without making these expenditures, he

stated that he would not want to be the one to try it; that he thought it would be disastrous (R. 171-174). Mr. Coffman was sales manager of petitioner for the years 1923 to 1926 and was very intimately acquainted with the donations which petitioner made. It is always necessary for a selling organization to maintain its good will and failure to make reasonable donations for the public good is one of the quickest ways to destroy that good will. While Mr. Coffman was not personally consulted regarding these Community Chest donations and while he did not have the say as to whether or not the donations should be made, it was his business as sales manager to be intimately acquainted with the policies and activities of this company, and he was thoroughly competent to state the purpose of making the donations and what the result would have been if the donations had not been made. Mr. Coffman's testimony on this point is fully corroborated by Mr. Richards (R. 270-271).

There was a time when both respondent and the Board of Tax Appeals refused to allow donations to the Community Chest as deductions in computing income, on the theory that they were not authorized by the law. But since the decision in the instant case, the Board has reversed its position and is now allowing Community Chest donations as deductions from income upon a showing that the corporation could not afford to refuse to make the donation and would suffer from a business standpoint if it did. Such was the evidence in the instant case and it is believed that, if the Board had this case now under consideration upon the record made, its decision would be favorable to petitioner rather than adverse.

In *The Evening Star Newspaper Co.*, 28 B. T. A. 762, promulgated July 7, 1933, the Board said:

> "The sole question for decision is whether the petitioner should be permitted to deduct from its gross income its contributions to the Washington Community Chest. Such a contribution when in the nature of a gift is deductible to a limited extent from the gross in-

come of an individual. Sec. 23 (n) (2), Revenue Act of 1928. No such deduction is allowed to a corportation. But either may deduct such a contribution when it is shown that the contribution is in fact a business expense. American Rolling Mill Co. *v.* Commissioner, 41 Fed. (2d) 314; Killian Co., 20 B. T. A. 80. Since a contribution may be either a charitable gift or a business expense, a taxpayer in order to secure a deduction as a business expense must show by sufficient evidence that the expenditure had in a direct sense a reasonable relation to its business (Thomas Shoe Co., 1 B. T. A. 124) or, as said in Killian Co., *supra,* it must be 'reasonably motivated by or related to the proper conduct of the business.' See also American Rolling Mill Co. *v.* Commissioner, *supra.* Tested by these standards we think that the petitioner has shown that its contributions were ordinary and necessary expenses within the meaning of section 23 (a) of the Revenue Act of 1928. Harris & Co. v. Lucas, 48 Fed. (2d) 187.

* * * * * * *

"Counsel for the respondent points out that the petitioner's witnesses were unable to show any specific gain in dollars arising from the contributions. This is an unreasonable demand. Alexander Sprunt & Son, Inc., 24 B. T. A. 599; Matson Navigation Co., 24 B. T. A. 14. It is sufficient that the directors had reasonable grounds to believe that their actions would be beneficial to the corporation. It was not necessary for them to expect additional gain. It was sufficient that they, with reasonable grounds, expected that it would prevent a loss. Kornhauser v. United States, 276 U. S. 145. Under either aspect we think the petitioner is entitled to the deductions claimed."

In a memorandum opinion, entered February 2, 1933, in the case of the *Killian Co.*, Docket 48053, the Board allowed as a deduction a donation made to the Community Chest of Cedar Rapids, Iowa. Since the financial depression came on and the Board's appropriation for expenses has been reduced, it has adopted the policy of entering a memorandum opinion in many cases rather than having opinions printed and published so that they can be cited in the reg-

ular way. Its decision in the *Killian Company* case, just cited, is an instance of that kind and this decision must not be confused with the former reported decision of the Board in the *Killian Company*, 20 B. T. A. 80, promulgated on June 16, 1930, which did not involve the question of deductibility of donations to the Community Chest.

As stated above, the earlier decisions of the Board were adverse to petitioner on this question, but these decisions were probably the result of failure on the part of petitioner to prove facts on which the Board could make a different holding. It is submitted that the Board reached the proper conclusion in *The Evening Star Newspaper Company, supra,* for the reasons therein stated, and that those reasons are equally applicable here. It is therefore submitted that the Board and the Circuit Court erred in refusing to allow the Community Chest donations as deductions in computing income.

VII. CONCLUSION.

In view of the foregoing it is submitted that this Honorable Court should reverse and set aside the decision and judgment of the Circuit Court of Appeals, Ninth Circuit, so far as it pertains to the two questions set out above and therein find and hold for petitioner.

Respectfully submitted,

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